

Investment

Alternative Investment Sees Rapid Growth

Timberland: The Natural Alternative

By: Clark S. Binkley & Leo de Bever

Timberland offers an alternative to institutional investors looking for better returns without unduly increasing risk. Clark S. Binkley, of the Hancock Timber Resource Group, and Leo de Bever, of MFC Global Investment Management, look at the returns and opportunities offered by this alternative investment.

Equity markets are moving sideways, fixed income looks risky, real-estate cap rates are falling, and too much money is flowing into hedge funds. The boom years of the late 1990s pushed benefit rates higher. The collision between higher payouts and lower returns has transformed rosy surpluses into worrisome deficits. How can investors earn better returns without unduly increasing risk?

Chile, Argentina, Brazil, and Uruguay.

Timberland investment currently attracts less than C\$20 billion of institutional capital, but has been growing at about 20 per cent per year since the first funds were launched in the early 1980s. This growth is not surprising given the favourable investment characteristics of the asset class – good real returns, low volatility, and, best of all, low or negative correla-

Canadian investors? Historical returns from timberland have averaged 14.1 per cent annually over 30 years¹, greater than the returns earned by such asset classes as equities, corporate bonds, and even real estate. Better still, timberland volatility over the period was comparable to Canadian large caps.

Timberland returns derive from a combination of income and capital gains. The income (or, more correctly, distributable cash flow) comes mainly from the sale of trees. However, there are other sources of income as well – recreational leases, rental income from antenna or windmill sites, and the sale of small tracts of land for development. Capital gains arise from the steady biological growth of trees and from the changes in the value of the timber and the underlying land. Careful, sustainable management of the forest can enhance growth rates and add to investor returns.

Diversification

There is virtually no correlation between timberland returns and returns from financial assets: equities or corporate



Surprisingly, part of the answer can be found in the woods. Timberland investment encompasses the equity ownership of forestland and the trees standing on it (sometimes investors own just the land or sometimes just the timber; however, most often, they own both). While most of this investment is in the United States, there are institutional holdings in Canada, Australia, New Zealand,

tion with most other assets, both financial and real. Let's examine each of these characteristics in a bit more detail, and then talk about some of the practical issues related to investing in this asset class.

Returns And Volatility

How has timberland fared in comparison with other assets that are available to

bonds. Interestingly, the correlation with commercial real estate and direct energy investments is negative as well.

This means that timberland can dramatically improve the risk-efficiency of a mixed-asset portfolio, allowing for reduced risk without sacrificing return. Indeed, based on the past 27 years of data, allocating 10 per cent of a broadly diversified

market portfolio to timberland would add about 40 basis points of return and reduce the standard deviation of the portfolio's returns by about 100 basis points. The portfolio's Sharpe ratio would increase by 22.9 per cent, to 0.43 from 0.35.

Practical Considerations

Although investment performance has piqued institutional interest in timberland, the availability of investment opportunities has fueled the growth in the asset class. Most of the timberland acquired by institutional investors has come either from forest products companies or from governmental privatizations. Forest products companies have come to understand that they do not need to own their own trees to be able to run their sawmills or pulp-mills. Indeed, the sale of timberland

Investments outside Canada may add currency exchange rate risk to the underlying volatility of timberland returns (although the empirical evidence suggests that these additional risks are not great for Canadians investing in the United States).

What about the risks? Top of mind for most investors is fire. Surprising to most, the actual losses from fire in a well-managed forest are negligible. Geographic diversification is a good way to control this and other sources of physical risk (insects, forest diseases, ice storms, and hurricanes.) Over the last 12 years, the losses from all Hancock Timber Resource Group-managed properties have averaged only four basis points per year.

Environmental issues also rank highly as a concern for some investors. To control these risks, it is important to invest with a

Next Steps

For those who find the timberland story compelling enough to learn more, we suggest three steps. First, there are numerous specialized websites with considerable information on the asset class². Second, most managers offer 'timber tours' to show clients and prospective investors actual operations on the ground. The day or two these tours take will reward you with a wealth of knowledge about the asset class. Finally, most of the managers – there are about 20 investment advisers for this asset class – will provide educational presentations and there are some very knowledgeable academics with a focus on the asset class.

The outlook for the sector is bright with global demand for wood products on the rise as populations grow and economies mature. Advances in tree-growing technology and environmental methods have made



can provide capital to improve their manufacturing facilities, to pay down debt, or to return to shareholders. Governments in many parts of the world have come to realize that forestry is well handled through private ownership and want to use the proceeds from privatizations to fund badly-needed social programs and physical infrastructure. As long as this restructuring of the forest sector continues, timberland will be available for investors and the supply is not likely to be much affected by conditions in capital markets.

At the moment, timberland appears to be priced to generate real (after-inflation) returns in the range of six per cent to 10 per cent. As with any asset, greater risks attend higher returns. In addition, there are strong regional differences in returns with, for example, greater volatility in timber prices in the U.S. Pacific Northwest than in the U.S. South and return expectations that are consistent with these differences in risk.

manager focused on long-term sustainable forest management who works closely with environmental groups and forestry experts to conform to 'best practices.' Sustainability certification is available, where third-party firms thoroughly review forest management practices to determine whether or not the investor's forests are being managed in a sustainable manner, including the protection of plants, soil, and water quality. Investing in plantation forests carries less environmental risk than does investing in natural forests, especially those in environmental 'hot spots' such as the Amazon Basin.

One of the biggest risks is the speed at which you can put money to work. Investment opportunities tend to be sporadic. Careful, specialized investor due-diligence is required to price these assets and to avoid costly mistakes. Patience will be rewarded by better long-term investment performance.

timberland a sustainable, ethical, and profitable business – and the natural alternative for pension funds looking to improve their return on total asset-liability risk. ■

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1. National Council of Real Estate Investment Fiduciaries (NCREIF) and HTRG Research, before fees, in CAN\$, for periods ending 12/31/03. NCREIF Timberland index reports actual returns of 268 U.S. institutional properties valued at US\$5.8 billion as of December 31, 2003.

2. A list of these websites may be found in the Resources section of the Hancock Timber Resource Group website at www.hancocktimber.com